

Whitney Hatch  
Vice President  
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96-98  
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EX PARTE OR LATE FILED

February 25, 1997

Mr. William F. Caton, Acting Secretary  
Federal Communications Commission  
1919 M Street, N.W., Room 222  
Washington, D.C. 20554

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FEDERAL COMMUNICATIONS COMMISSION  
OFFICE OF SECRETARY

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EX PARTE: Universal Service (CC Docket 96-45), Interconnection (96-98)

Dear Mr. Caton:

Today a representative of GTE Telephone Operations met with Jim Coltharp of Commissioner Quello's office to discuss considerations related to forward-looking cost estimation procedures. The issues discussed were filed previously in the record of CC Docket No. 96-98. The attached documents, also filed previously in this docket, were used to augment the discussion.

Please call me if you have any questions.

Sincerely,

Whitney Hatch

Attachment

c: J. Coltharp

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Before the  
**FEDERAL COMMUNICATIONS COMMISSION**  
 Washington, DC 20554

In the Matter of )

Implementation of the Local Competition )  
 Provisions in the Telecommunications )  
 Act of 1996 )

CC Docket No. 96-98

**RECEIVED**  
**FEB 26 1997**  
 FEDERAL COMMUNICATIONS COMMISSION  
 OFFICE OF SECRETARY

**AFFIDAVIT OF DUANE G. JOHNSON**

STATE OF TEXAS §  
 §  
 COUNTY OF DALLAS §

Duane G. Johnson, being duly sworn according to law, states as follows:

1. My name is Duane G. Johnson and I am Assistant Vice President-Regulatory and Governmental Affairs for GTE Telephone Operations. In that capacity I am responsible for, among other matters, preparing filings with the FCC, and determining the impact on GTE of various regulatory decisions.
2. I have over 25 years experience with GTE. During this time I have held various positions in regulatory relations, government affairs and marketing functions.
3. I have reviewed in detail the Federal Communications Commission's ("FCC") *First Report and Order* which was issued on August 8, 1996. This order establishes a framework of national rules implementing the local competition provisions of the Telecommunications Act of 1996.

4. The purpose of this affidavit is to describe two studies which were performed under my direction for the purpose of evaluating the accuracy and adequacy of the proxy cost and pricing in the *First Report and Order*. These analyses were performed to evaluate the differences between the proxy cost-based ceiling prices prescribed by the *First Report and Order* (at ¶¶ 788-827) for certain unbundled network elements as compared to the actual cost of providing those network elements.

5. The first analysis prepared under my direction is designed to determine the difference between the actual cost of a loop and the proxy cost adopted by the FCC as a basis for establishing a proxy price ceiling. The source data for determining the actual average cost of a loop was the "Universal Service Fund Annual Data Submission to FCC" submitted by the National Exchange Carrier Association (NECA) on September 29, 1995. This data is based upon filings made by local exchange companies with NECA in accordance with costing techniques specified by the FCC's Part 36. This data reflects actual costs for the year 1994, which is the latest available data. The costs include direct operating expenses, capital costs and allocated overheads. Investments are for the loops, as well as related support structures. These are the types of costs which the FCC stated would be eligible for inclusion in determining the cost of unbundled elements, even though the FCC specifies these should be estimated on a forward-looking basis.

6. The analysis converts the annual cost data found in the NECA report to a monthly amount so it can be directly compared to the FCC prescribed proxy ceiling costs/prices. The analysis shows that, with the exception of Nevada and Nebraska, the FCC proxy ceiling costs/prices are systematically well below the actual costs. Also, the results demonstrate that, even though the FCC model systematically understates the cost of loops, it does so in a very

inconsistent manner.. The net effect of the use of FCC proxy costs for the purpose of setting prices would result in a loss to GTE for almost every unbundled local loop provided to a competitor. The results of the loop cost analysis are shown on Attachment 1.

7. The second study prepared under my direction is designed to compare the actual costs for wholesale operations of a local exchange company, after adjusting retail costs using the FCC's "avoidable" cost standard applied to current rates, to the revenues produced by the ceiling prices specified by the FCC, which were set equal to the proxy costs for unbundled loops, unbundled switching and tandem switching. *First Report and Order* at ¶¶ 911-920. The analysis demonstrates that the FCC has adopted proxy costs that dramatically understate GTE's wholesale costs.

8. GTE Hawaiian Telephone Company (HTC) was selected as the basis for this analysis for two principal reasons. First, HTC provides telephone service throughout the state of Hawaii, thus avoiding the need to distribute loop costs among multiple companies based upon their relative service area densities, i.e., the FCC's geographical deaveraged rates. Second, HTC has recently been involved in an intrastate rate case proceeding. As a result, more detailed data are readily available for that company than would be the case normally. This fact allowed the analysis to be done in a short amount of time, compared to what would have been required if the analysis had been conducted on another company. Also, in this rate proceeding all of the costs of HTC were examined, and new rates have been put into place which are approximately equal to the aggregate of the cost of providing local, access and toll services in that state.

9. If the FCC's proxy cost methods produce results which are also similar to the current cost-based revenues, then the FCC's methods could be considered to yield a good approximation of the actual cost of wholesale operations. On the other hand, if the FCC's proxy cost methods

produce rates which over- or under-recover cost, then the FCC's methods can be considered to be poor cost estimation tools. Using revenues as a surrogate for the aggregate cost of service is appropriate for this analysis because the current HTC services, which use the same equipment as the FCC's unbundled elements, have very different pricing structures from those required by the FCC. For example, local, state access, and interstate access switched services use the same network elements as the FCC's unbundled switching element. However, HTC's services are a combination of fixed and usage sensitive prices that vary with the identity of the consumer, while the FCC's proxy price of \$.002 to \$.004 per minute for the unbundled switching element is only usage sensitive, but serves the same function. The most convenient way to compare the underlying cost estimates used to develop these different rate structures is to compute and compare the aggregate revenues which would be produced by the actual and proxy cost-based prices.

10. The analysis is based on the fact that, in aggregate, today's prices recover GTE's total cost of providing all of its services. Thus, at an aggregate level, the difference between current revenue, adjusted for the FCC's estimate of avoided retail cost, and the revenue which would be produced if the services were repriced at the proxy cost-based ceiling prices specified by the FCC, can be used to demonstrate the arbitrariness of the FCC's proxy cost methods and price ceilings.<sup>1</sup>

11. The results of the HTC revenue/cost analysis presented in Attachment 2, demonstrate that the proxy cost-based ceiling prices prescribed by the FCC for use by state commissions, if

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<sup>1</sup> Even though GTE believes the FCC's prescribed range of avoided cost is too high, the lower end of the FCC's range of avoided retail cost of 17% was used to adjust current revenue in order to reduce the conflict over the analysis. Therefore, the results are conservatively stated.

applied to HTC, would result in an under-recovery ranging from approximately \$117 to \$130 million per year. Even with the inclusion of the temporary CCL and TIC charges, the revenue would fall short by from \$79 to \$91 million per year. However, the inclusion of these amounts would understate the magnitude of the FCC's error.

12. This under-recovery of cost would not result from competitive market forces, nor do the differences between the FCC's proxy cost estimates and actual cost represent indications of operating inefficiencies. Rather, they are the result of errors made by the FCC in the application of inappropriate and inaccurate cost data and cost study methods for the purpose of setting proxy ceiling prices. It is also the result of essentially repricing access services under the label of unbundled elements, each of which were priced on the basis of different costing methods. Prices of access services are currently based upon average costs. The FCC has specified the use of incremental cost as the basis for pricing unbundled elements. However, the FCC failed to include much of the relevant cost of providing network elements because it relied upon cost studies which were not based upon the FCC's own TELRIC principles. Also, the FCC neglected to deal with the lack of cost recovery in services under their jurisdiction which would be the expected consequence of their action.

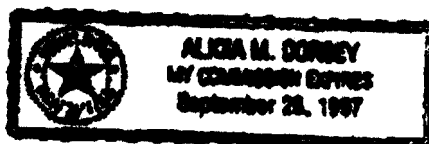
NOTARY

*Alicia M. Dorsey*  
Signature

*Duane G. Johnson*  
Duane G. Johnson

*Alicia M. Dorsey*  
Printed Name

SEAL



Date *August 27, 1996*

**Attachment 1**

**Affidavit of Duane G. Johnson**

**Comparison of Proxy Loop Rates to Actual Loop Cost<sup>1</sup>**

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<sup>1</sup> Actual loop cost computed from the "Universal Service Fund Annual Data Submission to FCC" submitted by the National Exchange Carrier Association dated September 29, 1995.

**Comparison of Proxy Loop Rates to Actual Loop Cost**

STATE	PROXY CEILING LOOP RATE/MO	WEIGHTED LOOP COST/MO	
		STATE AVERAGE	GTE AVERAGE
ALABAMA	\$17.25	\$22.04	\$30.25
DISCOUNT TO PROXY		21.7%	27.1%
ARKANSAS	\$21.18	\$28.15	\$34.04
DISCOUNT TO PROXY		24.8%	37.8%
CALIFORNIA	\$11.10	\$17.21	\$25.07
DISCOUNT TO PROXY		35.5%	55.7%
ARIZONA-Cal.	\$12.85	\$23.30	\$42.80
DISCOUNT TO PROXY		44.8%	70.0%
NEVADA-Cal	\$18.95	\$15.53	\$26.53
DISCOUNT TO PROXY		-22.0%	28.6%
FLORIDA	\$13.68	\$25.10	\$25.05
DISCOUNT TO PROXY		45.5%	45.4%
HAWAII	\$15.27	\$23.09	\$23.09
DISCOUNT TO PROXY		33.9%	33.9%
IDAHO	\$20.16	\$25.86	\$36.19
DISCOUNT TO PROXY		22.0%	44.3%
ILLINOIS	\$13.12	\$13.95	\$19.78
DISCOUNT TO PROXY		5.9%	33.7%
INDIANA	\$13.29	\$19.26	\$22.33
DISCOUNT TO PROXY		31.0%	40.5%
IOWA	\$15.94	\$16.82	\$22.61
DISCOUNT TO PROXY		5.2%	29.5%



### Comparison of Proxy Loop Rates to Actual Loop Cost

STATE	PROXY CEILING LOOP RATE/MO	WEIGHTED LOOP COST/MO	
		STATE AVERAGE	QTE AVERAGE
KENTUCKY	\$16.70	\$24.53	\$28.51
DISCOUNT TO PROXY		31.9%	41.4%
MICHIGAN	\$15.27	\$18.90	\$27.05
DISCOUNT TO PROXY		19.2%	43.5%
MINNESOTA	\$14.81	\$19.05	\$25.15
DISCOUNT TO PROXY		22.2%	41.1%
MISSOURI	\$18.32	\$21.02	\$34.64
DISCOUNT TO PROXY		12.9%	47.1%
NEBRASKA	\$18.05	\$18.05	\$20.84
DISCOUNT TO PROXY		-0.0%	13.4%
NEW MEXICO	\$18.66	\$26.09	\$27.86
DISCOUNT TO PROXY		28.5%	33.0%
NORTH CAROLINA	\$16.71	\$25.10	\$26.49
DISCOUNT TO PROXY		33.4%	36.9%
OHIO	\$15.73	\$18.94	\$23.16
DISCOUNT TO PROXY		17.0%	32.1%
OKLAHOMA	\$17.63	\$23.00	\$32.12
DISCOUNT TO PROXY		23.3%	45.1%
OREGON	\$15.44	\$23.00	\$22.94
DISCOUNT TO PROXY		32.9%	32.7%
PENNSYLVANIA	\$12.30	\$17.82	\$21.09
DISCOUNT TO PROXY		31.0%	41.7%

**Comparison of Proxy Loop Rates to Actual Loop Cost**

STATE	PROXY CEILING LOOP RATE/MO	WEIGHTED LOOP COST/MO	
		STATE AVERAGE	GTE AVERAGE
SOUTH CAROLINA	\$17.07	\$28.82	\$25.12
DISCOUNT TO PROXY		40.8%	32.1%
TEXAS	\$15.49	\$22.02	\$27.93
DISCOUNT TO PROXY		29.6%	44.5%
VIRGINIA	\$14.13	\$21.00	\$24.54
DISCOUNT TO PROXY		32.7%	42.4%
WASHINGTON	\$13.37	\$19.59	\$23.70
DISCOUNT TO PROXY		31.7%	43.6%
WISCONSIN	\$15.94	\$18.32	\$25.94
DISCOUNT TO PROXY		13.0%	38.5%

**Attachment 2**

**Affidavit of Duane G. Johnson**

**Comparison of GTE Hawaiian Telephone Revenues from Current Prices**

**to**

**Revenues from FCC Proxy Prices**

680,178,716

**(70,764,005)**  
**(30,522,000)**

(1517, 207, 007)

## NOTES TO REVENUES CALCULATIONS

### GTE HAWAIIAN TELEPHONE

#### PRESENT REVENUE

- R-1, B-1, PBX trunk and Touch Call units and rates are as presented in the GTE Hawaiian Telephone's 1995 rate case. Units are in service units, and rates are effective rates.
- Custom Call units and rates are based on actual current data..
- The Local Service Revenue sub-total of \$169 million represents approximately 72% of total annual Local Service Revenue presented in the Company's 1995 rate case. The remaining 28% of annual Local Service Revenue or \$66 million which is not included in this analysis is made up of various local service revenue streams such as Public Telephone Revenue, Private Line Revenue, Operator Service and Directory Assistance Revenue, Mobil Revenue, Non-recurring Revenue, Centranet Revenue, Hawaii Public Utility Commission (PUC) Surcharge, and 911 Surcharge revenues. Most of the notes for these services will be unaffected by the FCC proxy price ceilings.
- On August 1, 1996, the Hawaii PUC released its Interim Decision and Order No. 14833 in combined Docket Nos. 94-0298 and 95-0194. This order granted GTE Hawaiian Telephone an increase of \$17.937 million in local rates. Because, as noted above, only 72% of total local service revenue is included in this analysis, that portion of the increase (\$12,914,640) was apportioned to the current local service revenue column of the analysis.
- The Local Service Revenue category is adjusted for estimated avoided costs by applying a 17% rate to the revenue. While GTE does not support this level of adjustment, the analysis has been conformed to the interconnection order to avoid controversy.
- Subscriber Line Charges (SLC) revenues are calculated utilizing the consistent access line units from the analysis and appropriate current rates.
- Interstate Access CCL, End Office Minutes of Use, and effective rates are based on actual current data.
- CCL minutes and revenue are included in the analysis in order to demonstrate the magnitude of revenue that will be exposed to loss when orders are released in the Access Reform and Universal Service phases of implementation or by June 30, 1997.

- Interstate Access Tandem Minutes of Use were developed by applying an 82% factor to the End Office Switching Minutes of Use. The factor is from GTE's March 1995 Interstate Price Cap Filing, and represents the per cent of interstate access minutes which flow through a Tandem Switch.
- State Access Minutes of Use and associated revenues is represented by two individual and combined calculations.
  - a. Intrastate Access Charge Minutes of Use and rates for End Office, Tandem Switching, and RIC/TIC are based on information filed with the Hawaii PUC in July 1995, pursuant to Docket No. 7702.
  - b. End Office, Tandem Switching, and RIC/TIC Access Charge Minutes of Use were converted from Intrastate Toll Minutes by applying an access charge two-way factor of 1.90858 to the annual Toll Minutes. Current tariff rates for intrastate access charges were utilized to calculate revenues from these minutes.
- CMRS data was supplied by individuals responsible for CMRS contract administration.

#### **REVENUES FROM FCC PROXY PRICES**

- Rates used to compute revenues are based on the proxy price ceilings mandated in the FCC's CC Docket No. 96-98, *First Report and Order*, released August 8, 1996.
- Network Interface Devices (NID) units were developed based on a one-for-one ratio applicable to R-1s and a one-for-three ratio applicable to B-1a. The monthly rate of \$.71 is based on costs developed specifically for Hawaii for R-1/B-1 NIDs.
- Local End Office Switching Minutes of Use were calculated based on data collected from several offices in studies of local traffic performed during the period May through July 1992. The data indicated that average local messages per month per residence access line totaled 200, and average holding times per message was 3.03 minutes. Average local messages per month per business line totaled 195 messages, and average holding time per message was 1.83 minutes.
- Local Tandem Switching Minutes of Use were developed by applying the 82% interstate conversion factor to Local End Office Switching Minutes of Use. Thus, it is assumed that the same ratio of local minutes will require tandem switching as was the case for interstate minutes.
- RIC/TIC rates are 75% of the present RIC/TIC rates.

## **RESULTS**

- Revenue shortfalls from the analysis stated in terms of a percent reduction from the base revenue of \$268 million are \$91 million or 34% under the low limit scenario and \$79 million or 29% under the upper limit scenario.
- The base revenue of \$298 million (before adjustment for avoided costs) represents 61% of the estimated total annual revenue for GTE Hawaiian Telephone.
- GTE Hawaiian Telephone represents approximately 5% of the GTE domestic telephone access lines.

**Certificate of Service**

I, Judy R. Quinlan, hereby certify that copies of the foregoing "Joint Motion of GTE Corporation and the Southern New England Telephone Company for Stay Pending Judicial Review" have been mailed by first class United States mail, postage prepaid, on the 28th day of August, 1996 to all parties of record.

Judy R. Quinlan  
Judy R. Quinlan



## CENTRAL OFFICE ANALYSIS

ITEM	SAN ANGELO SE		AZLE	
	@ .004/MIN	@ .002/MIN	@ .004/MIN	@ .002/MIN
LINES	17,458	17,458	6,819	6,819
SWITCH INVESTMENT	\$7,045,234	\$7,045,234	\$3,210,000	\$3,210,000
MINUTES/MONTH	10,893,753	10,893,753	11,811,072	11,811,072
ANNUAL COSTS				
OPERATING EXPENSES				
MAINTENANCE	\$588,748	\$588,748	\$258,583	\$258,583
ADMIN AND OVERHEAD	\$1,003,101	\$1,003,101	\$457,039	\$457,039
DEPRECIATION	\$177,188	\$177,188	\$80,732	\$80,732
RETURN ON INVEST.	\$778,488	\$778,488	\$364,705	\$364,705
COMPOSITE TAX	\$58,532	\$58,532	\$27,125	\$27,125
LAND & BUILDINGS	\$679,865	\$679,865	\$308,765	\$308,765
PROPERTY TAX	\$88,043	\$88,043	\$31,458	\$31,458
TOTAL ANNUAL COST	\$3,338,975	\$3,338,975	\$1,520,417	\$1,520,417
LESS 17% AVOIDED	\$567,286	\$567,286	\$258,471	\$258,471
ADJUSTED ANNUAL COST	\$2,769,689	\$2,769,689	\$1,261,946	\$1,261,946
COST/MO (ANN. COST/12)	\$230,807	\$230,807	\$105,162	\$105,162
TELRIC/MIN	\$0.004	\$0.002	\$0.004	\$0.002
USAGE REVENUE	\$43,575	\$21,788	\$47,244	\$23,622
COMMON COST/MO	\$187,232	\$209,020	\$57,918	\$81,540
COMMON COST/LINE/MO	\$10.72	\$11.97	\$8.75	\$12.32
% UNRECOVERED USING PROXY	81.1%	90.6%	55.1%	77.6%

# Conceptual Local Exchange Network Costs

